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Corporate Governance Mechanisms and Bank Performance: Resource-based View

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Abstract

The high profile accounting scandals, for example, WorldCom and Enron, have intensely impacted the nation and world economies. These events had ignited the importance of implementing good corporate governance mechanisms for companies, including the banking sector in Malaysia. Using the resource based theory, this paper examined the corporate governance mechanisms specifically the ownership monitoring mechanism, internal control monitoring mechanism (board independence and board size), and regulatory mechanism (capital adequacy ratio) influence on the bank performance. The sample of 18 banks (from 2009 to 2013) was collected from Thompson Reuters Worldscope database. The regression analysis has been employed to accomplish the objective of this paper. Based on the results, regulatory monitoring mechanism was found to be a significant influence on bank performance. Findings from this paper would assist the Central Bank of Malaysia and the Securities Commission to formulate strategies for the banking sector to fully comply with the Malaysian Code of Corporate Governance 2012. In addition, banks in Malaysia would be able to identify resources that need to be prioritized in attaining higher performance.

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Keywords: Corporate governance; bank; corporate performance; resource based theory

1. Introduction

Accounting scandals in the United States (U.S.) corporate world particularly the Enron and Worldcom invited debates on the integrity of corporate financial reporting. The widespread failure in financial reporting has largely been blamed on weak corporate governance mechanisms (Abdul Rahman, 2006). The Malaysian Code of Corporate Governance (MCCG) 2012 focuses on strengthening board structure and composition recognising the role of directors as active and responsible fiduciaries. The Code stated that the board of directors have a duty to be effective

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stewards and guardians of the company, not just in setting strategic direction and overseeing the conduct of business, but also in ensuring that the company conducts itself in compliance with laws and ethical values, and maintain an effective governance structure to ensure the appropriate management of risks and level of internal controls apart from taking care of the stakeholders' interest. Therefore, in ensuring the compliance with laws and ethical values, the requirement of timely and high quality disclosure for all companies has been included as the seventh principle in the MCCG 2012 and the Bursa Malaysia Listing Requirements. Disclosure is the foundation of any structure of corporate governance (Bhasin, 2012) which is generally found in most annual reports.

The objective of this paper is to examine the relationship between corporate governance and bank performance in Malaysia. Resource-based theory is applied in explaining the relationship between corporate governance mechanisms and bank performance. The investigation is based on the assumption that banks are involved in greater information asymmetries and complexity of business transactions are at a higher level when compared with non-banks (Andres and Vallelado, 2008). Business complexities can be in the form of loans quality that are not being clearly perceived, financial engineering that is not transparent, complicated financial statements, easily modified investment risk, or accessibility of perquisites information for managers or insiders. The relevance of corporate governance on banks is different from non-financial companies due to specific requirement by the Financial Services Act (2013) formerly known as Banks and Financial Institutions Act (1984). Besides, basis for banking sector is treated under greater information asymmetries and plays an important role in regulating the economies (Alexander, Baptista, and Yan, 2013).

1.1 Resource based theory

Resource-based theory suggests that the resources possessed by a firm are the primary determinants of its performance, and this may contribute to the sustainable competitive advantage of the firm (Wernerfelt, 1984). Corporate governance mechanisms are categorized as firm's resources (Barney,1991; 1996; 2001; Wernerfelt, 1984). The resource-based view is a basis for sustainable competitive advantage of a firm that consists of valuable, tangible and/or intangible resources at the firm's own used however; these resources are heterogeneous in nature and not perfectly movable without proper management (Barney et al., 2001; Barney, 1991). Proper management is related to an organization in having good corporate governance as it has become one of the most important elements in evaluating firm's performance and sustainability. The implementation of a strategy to achieve sustainable competitive advantage is unlikely to follow automatically (Barney, 2001). Even though the most common definition of corporate governance is as an institutional "best practice" but it does not mean that it can stand on its own to be the source of competitive advantage. Therefore, the role of board of directors is critical in determining the achievement of sustainable competitive advantage of the firm through corporate governance. It is supported by Abdul Rahman (2006) that the board of director is responsible to three primary roles that include monitoring/control role, service/expertise/counsel role, and resource dependence role. Resource-based theory requires the board members to facilitate the acquisition of resources such as capital and business partnerships that are critical to the success of the organization.

Wernerfelt (1984), cited that resource-based theory underlines the role of independent directors which is supposedly to bring the unique resources to the firm and it is the task of the management team to gather and deploy the unique assets of the independent directors to achieve the competitive advantage goal of the firm. Barney (1991) further contributes on the research and suggested that heterogeneity of firm's various resources determined the firm's sustainable competitive advantage. In an ever changing environment, organization must continuously acquire, develop and upgrade its resources and capabilities to maintain competitiveness and growth (Wernerfelt, 1984). Some researchers describe capabilities as luck (Barney, 1996), whereas others describe capabilities as experiential learning by organizations (Drago, 1995), and the more managerially inclined emphasize the role played by leaders of organizations (Lakshan and Wijekoon, 2012).

2. Hypotheses Development

Using the resource based view as an underlying theory, five hypotheses were developed in this paper:

2.1 Ownership

It is likely that if a foreign bank has some ownership of a local bank, there would be some transfer of knowledge and technology at least with respect to the operational styles and management strategies from the foreign bank to the local bank (Liang et al., 2013). The foreign owners may influence the bank management to adapt a more transparent, competitive and efficient operating strategy and might even have an input and influence in selecting the top management. This affirms Barney's resource-based theory in strategic choice emphasizing on the capability of firm's management in identifying, developing and deploying its resources to maximize profit. Therefore, it enables banks with more foreign ownership to outperform the other banks with limited exposure and experience.

In addition, enhanced corporate governance will lead to long-term performance improvement. Empirical evidence found in Chinese bank that foreign minority investors exert a positive influence on the prudent behavior of Chinese banks through an improved corporate governance system (Hasan and Xie, 2013). Foreign ownership does improve banks performance in terms of its influence on the local owned bank to improve further on the organization's corporate governance. With the improved corporate governance, locally owned banks are in a better position to manage its resources and harmonized with improved corporate strategies in maximizing returns due to the information asymmetries possessed by local owned banks. Williams and Nguyen (2005) supported this notion in the study conducted on changes in bank corporate governance impacts on bank performance. By having improved corporate governance, and converged with the boards' capabilities in integrating these resources into outputs, will in turn, generate profitable outcomes and improved bank performance. Hence, the developed hypothesis is as follows:

H1: There is a negative relationship between foreign ownership and bank performance.

2.2 Board independence

Berger and Bowman (2013) advise that independent directors in the local banks are in a better position to provide information exchange because the independent directors have the advantage in accessing other firm's privately owned data that might unseal favourable opportunities for the firm. Stepnova and Ivantsova (2012) found a positive relationship between board independence and bank performance. This is due to the outside knowledge and experience being brought into the organization that will eventually turn as unique resources for the organization. In spite of that, according to Andres and Vallelado (2008), an optimum number of independent directors together with the organization executive directors are creating value for the organization. It can be summarized that greater board independence enables its members to take moderate decisions and also compensates management according to their performance. In line with the resource-based theory, the presence of more outside directors on the board, the more outside resources will be available to be embedded in the strategy in achieving higher profits and returns. This brings to the developed hypothesis as follows:

H2: There is a positive relationship between board independence and banking sector performance.

2.3 Board size

Adams and Mehran (2012) supported that there is a positive relationship between board size and bank performance. According to resource-based theory, the larger the board size the more resources are available. For instance, board of directors from different education background and work experience are gathered on the board to assist the management in decision making to achieve the corporate objective. Germain et. al., (2012) finding is in congruence with resource-based theory's perspective which implies that boards with more directors are able to delegate more human resource to supervise and advise on managers' decisions. However, larger boards are ineffective due to coordination issues along with the problems of free riding. To control this, firms have to bear high coordination costs. Majority of the literature of corporate governance discussed the advantages of smaller boards in the firm. It was also proven that in a study conducted by Liang et al. (2013) smaller boards are strongly connected, more efficient and able to monitor the firm more effectively. The above discussion leads to the fact that board size has a negative relationship with bank performance in Malaysia. The reason is that more human resource does not necessarily imply effective monitoring by the board members. Thus, the developed hypothesis is as follows:

H3: There is a negative relationship between board size and bank performance.

2.4 Regulatory monitoring

Capital adequacy ratio regulations are uniquely established for and applied to banks. By definition, the capital adequacy ratio is a measure of the amount of a bank's capital expressed as a percentage of its risk weighted credit exposures. The purpose of having a minimum capital adequacy ratio is to ensure that banks can absorb a reasonable level of losses before becoming insolvent and before depositors funds are lost. The Basel Capital Accord sets minimum capital ratios of not less than 8 percent (Central Bank of Malaysia, 2013), which the supervisory authorities are encouraged to apply. Extensive literature has been documented pertaining to the role of capital in preventing banks failures and the use of capital adequacy ratio in predicting bankruptcies. Berger and Bowman (2013) emphasized that capital adequacy serves as an indicator of the banking system and suggest a strict enforcement of capital adequacy rules as one of the policy measures in a banking crisis. The banking industry often requires a careful analysis of its risk management function due to its high leverage and high-risk characteristics. Williams and Nguyen (2005) argue that capital regulation, particularly in banks, protects consumers and depositors as well as reduces systemic risk. Based on the literature, it can be implied that higher capital adequacy ratio would represent more assets are allocated to for the bank liquidation risks.

Meanwhile, Berger and Bouwman (2013) found that few banks really expand their capital adequacy ratios when they are introduced to higher illiquidity market. From resource-based theory perspective, Kalyvas and Mamatkis (2014) imply that higher capital adequacy ratio indicates more assets are to be liquidated if necessary to protect the banks from going into bankruptcy. Thereby, lesser resources would be channeled to business activities that might improve the banks performance. Thus, the hypothesis development is as follows:

H4: There is a negative relationship between capital adequacy ratio and bank performance.

3. Research Methodology

The sample was collected from Thompson Reuters Worldscope database. The database was selected instead of banks listed in Bursa Malaysia due to all banks, foreign or Malaysian locally owned, are listed in the database. In contrast, most foreign banks and some local banks are not listed on Bursa Malaysia's webpage. The sample data of 27 banks in Malaysia is considered small in number compared to the 52 samples collected by Praptiningsih (2009) subtracted from Indonesia, Thailand, Malaysia and Philippines Stocks Exchange Market. Out of the 27 banks in Malaysia, the required information for the period of 2009 to 2013 is only available from 18 banks in Malaysia. Hence, the sample for this paper is from 90 (18 X 5) observations.

3.1 Measurement of variables

This paper employed Return on Asset (ROA), signifies the actual productivity of banks, as the measurement for bank performance (Pathan and Faff, 2013). This paper used the dummy variable in measuring the foreign ownership of a company where it is equal to "1" if the bank is a foreign ownership and "0" if otherwise (Amran and Haniffa, 2011). The measurement of board independence was the ratio of outside directors against total directors on the board (Waqar et al., 2013; Liang et al., 2013; Praptiningsih, 2009). This paper employed the number of directors on the board as measurement for board size (Hasan and Xie, 2013; Praptiningsih, 2009). This paper measured the bank size by using total assets. The measure of the amount of a bank's capital is expressed as a percentage of its risk weighted credit exposure (Mehta et al., 1979).

4. Results and Discussions

A multiple regression analysis was performed to examine the relationship between corporate governance mechanisms and bank performance. Prior to conducting multiple regressions, several assumptions have been met. The summary of the regression results is presented in the Table 1.

Table 1. Regression results

	Coefficients	t-statistics	P-Value

	(Beta)		
(Constant)		-7.524	.000
Firm Size	.108	.850	.398
Board Independence	-.151	-1.417	.160
Board Size	-.188	-1.523	.132
Capital Adequacy Ratio	-.444	-4.201	.000***
R^2	.300		
Adj. R^2	.256		
F-statistics (P-value)	6.930 (.000)***		
Df	(5,81)		

Note: *** Significant at 0.01 level, ** Significant at 0.05 level, *significant at 0.1 level

The result from Table 1 reveals that only the capital adequacy ratio has a significant relationship with the bank performance. The overall explanatory factors of return on assets were statistically significant at 1% significant level with adjusted R-squared of 0.256 (p-value = 0.000). This result suggested that only 26% variance in return on assets could be explained by the independent variables in the model. The adjusted R-squared also summarized the fit of the model as it took into account the number of variables in the model. The R-squared for this paper, 0.300, is higher than Praptiningsih (2009) that has obtained R-squared of 0.096 in examining the relationship between corporate governance mechanism and bank performance among four Asian countries.

Furthermore, regression results discovered that there is a negative significant relationship between capital adequacy ratio and ROA at 1% significant level (p-value = 0.000). This indicates that a decrease in capital adequacy ratio could increase the corporate performance of banks in Malaysia. This result is supported by the study conducted by Berger and Bowman (2013) and Kalyvas and Mamatkis (2014). On the contrary, the result produced by Praptiningsih (2009) shows a positive relationship between capital adequacy ratio and bank performance. Praptiningsih tested the analysis using two different models which include with and without the foreign ownership variable as well as with some government intervention. Thus, the fourth hypothesis is hereby supported. In spite of that, this result is consistent with the resource-based theory that resources availability for strategic performance helps to improve and maximize corporate performance (Berger and Bowman, 2013).

In contrast, the first, second and third predictors recommended a different result when the foreign ownership, board independence and board size have no significant relationship with bank performance (p-value = 0.247), (p-value = 0.160), and (p-value = 0.132) respectively. This indicates that foreign ownership, board independence and board size do not affect corporate performance for banks in Malaysia. Due to this reason, the first, second and third hypotheses are not supported. This result is inconsistent with Liang et. al. (2013) whereby it was found that there is a negative relationship between foreign ownership and corporate performance. However, the result is supported by Waqar et al. (2014) and Hermalin and Weisbach (1991). In resource-based theory perspective, it may be due to outflow of resources such capital resources to pay for high skilled foreign workers wages that limits the resources channeled productivity purposes.

For Hypothesis 2, the result produced in this paper is inconsistent with the finding by Andres and Vallelado (2008), Liang et al. (2013), and Waqar et al. (2014) which supported that there is a positive relationship between board independence and bank performance. On the other hand, studies conducted by Germain et al. (2014) and Hermalin and Weisbach (1991) found no significant relationship with board independence and corporate performance. The reason is explained by resource-based theory, that is larger number of outside directors on the board may in turn having a duplication of resources which might no longer be valuable, rare, inimitable and non-substitutable for the bank.

As for hypothesis 3 predictions, the result from this paper is in contrast with the empirical result for studies conducted by Andres and Vallelado (2008), Germain et al. (2012) and Liang et al. (2013). Nevertheless, the insignificant result is supported by Waqar et al. (2014) and Kumar and Singh (2013). The reason is due to larger boards may face decisions making problem such as coordinating and allocating of resources in strategic management.

Overall, it could be concluded that there exist a relationship between the corporate governance mechanism and bank performance in Malaysia. The relationship is significant but there are inconsistencies in each corporate governance mechanism to suggest the best corporate governance characteristic that a bank should employ to achieve superior performance.

5. Conclusion

The objective of this paper is to examine the relationship between corporate governance mechanisms and bank performance in Malaysia. In particular, this paper is investigating how does the existence of foreign ownership, independent board of directors, size of board of directors, and capital adequacy ratio could influence banks' performance in Malaysia. The multiple regression analysis, while controlling the effect of size as measured by total assets, is conducted to confirm the significance of the relationships. It was empirically proven that only capital adequacy ratio has a significant negative relationship with bank performance in Malaysia. Lower capital adequacy ratio implies that there will be more assets available for the banks to utilize to achieve its vision and mission and consistent with Kalyvas and Mamatkis (2014) argument.

This paper is expected to contribute to relevant literature to a certain extent. Generally, this paper provides an understanding on the level of corporate governance mechanisms' influence on banks' performance in Malaysia with an attempt to highlight the influence of the revised MCCG 2012. Empirical evidence resulted from this paper contributes to the existing literature in identifying the relationship between corporate governance mechanisms and banking sector performance through resource-based theory perspective and helps the banks to obtain a thorough understanding in managing resources reasonably to achieve the desired maximum performance. Thus, findings from this paper could assist the Central Bank of Malaysia and the Securities Commissions to focus on governance mechanisms key areas that are critical in improving bank performance. Furthermore, it enables the Central Bank of Malaysia and the Securities Commission to formulate strategies to further improve the level of compliance among the financial institutions to the recommendations stated in MCCG 2012 while adhering to the Financial Services Act 2013 requirements.

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